

SURREBUTTAL TESTIMONY OF

DAVID C. PARCELL

ON BEHALF OF

THE SOUTH CAROLINA OFFICE OF REGULATORY STAFF

DOCKET NO. 2019-281-S

IN RE: APPLICATION OF PALMETTO UTILITIES, INC. FOR

ADJUSTMENT (INCREASE) OF RATES AND CHARGES, TERMS AND

CONDITIONS, FOR SEWER SERVICE PROVIDED TO CUSTOMERS IN

ITS RICHLAND AND KERSHAW COUNTY SERVICE AREAS

Q. PLEASE STATE YOUR NAME, ADDRESS, AND OCCUPATION.

A. My name is David C. Parcell. I am a Principal and Senior Economist of Technical Associates, Inc. My address is 2218 Worchester Road, Midlothian, Virginia 23113.

Q. DID YOU FILE DIRECT TESTIMONY AND EXHIBITS IN THIS PROCEEDING?

A. Yes. I filed Direct Testimony and two (2) exhibits with the Public Service Commission of South Carolina (“Commission”) on May 26, 2020.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. The purpose of this Surrebuttal Testimony is to respond to the Rebuttal Testimonies of Palmetto Utilities, Inc. (“PUI” or “Company”) witnesses Harold Walker, III and Donald J. Clayton. Mr. Walker’s Rebuttal Testimony is generally focused on the following topics: ownership of PUI, capital structure issues, proxy group, risk factors, Discounted Cash Flow (“DCF”) issues, Capital Asset Pricing Model (“CAPM”) issues, Comparable Earnings (“CE”) issues, and overall cost of equity (“ROE”) issues. Mr. Clayton’s Rebuttal

Testimony mimics part of Mr. Walker's Rebuttal Testimony on the issue of capital structure.

My surrebuttal testimony accordingly is organized to respond to the criticisms of each of these topics.

Q. DOES ANYTHING CITED IN MR. WALKER'S AND MR. CLAYTON'S REBUTTAL TESTIMONIES CAUSE YOU TO CHANGE YOUR RECOMMENDATION IN THIS PROCEEDING?

A. No.

I. OWNERSHIP STRUCTURE OF PUI

Q. MR. WALKER STATES, ON PAGES 6-7 OF HIS REBUTTAL TESTIMONY, THAT YOU ARE MAINTAINING THAT PUI HAS LOWER RISKS DUE TO ITS OWNERSHIP BY NI PACOLET MILLIKEN UTILITIES AND THAT YOU ARE RECOMMENDING "SOMETHING LESS THAN A FAIR RATE OF RETURN" DUE TO THIS OWNERSHIP. IS HE CORRECT IN HIS ASSERTIONS?

A. No, he is not correct. What I do demonstrate in my Direct Testimony (pages 18-19) is that PUI is owned by Ni Pacolet Milliken Utilities, LLC ("Ni"), as are other utilities in South Carolina and other states. PUI's debt capital is apparently arranged by Ni and, in fact, a significant portion of PUI's debt is in the form of intercompany loans within the Ni "family."

Mr. Walker is apparently proposing that this relationship be ignored and PUI be considered as a "stand-alone" entity that raises all its capital on its own behalf. This is simply not the reality of the Company's situation. Further, my Direct Testimony does not

1 make any downward adjustment to “something less than a fair rate of return” due to the
2 ownership of PUI by Ni.

3 **Q. DOES YOUR 9.55 PERCENT COST OF EQUITY FOR PUI REFLECT**
4 **“SOMETHING LESS THAN A FAIR RATE OF RETURN”?**

5 **A.** No, it does not. As I indicate in my Direct Testimony (page 17), my 9.55 percent
6 cost of equity for PUI is consistent with other ROE awards for water/wastewater utilities
7 throughout the U.S. in recent years. In contrast, Mr. Walker’s 10.50 percent cost of equity
8 recommendation substantially exceeds the recently-authorized returns on equity for
9 water/wastewater utilities in South Carolina and the U.S.

10 **II. CAPITAL STRUCTURE ISSUES**

11 **Q. WHAT ARE THE RESPECTIVE CAPITAL STRUCTURE ISSUES IN THIS**
12 **PROCEEDING?**

13 **A.** PUI, through the Direct and Rebuttal Testimonies of Mr. Walker, is proposing a
14 capital structure comprised of 41.79 percent debt and 58.21 percent common equity. PUI
15 refers to this as its “actual” capital structure.

16 In my Direct Testimony, I propose a hypothetical capital structure with 45 percent
17 debt and 55 percent common equity. This reflects the approximate capital structure ratios
18 of the proxy groups used to develop the ROE in both mine and Mr. Walker’s testimonies.

19 **Q. IN HIS REBUTTAL TESTIMONY (PAGE 8, LINES 17-18), MR. WALKER**
20 **STATES THAT YOU “DID NOT PRESENT ANY EVIDENCE PROVING PUI’S**
21 **ACTUAL CAPITAL STRUCTURE IS UNREASONABLE.” DO YOU AGREE**
22 **WITH MR. WALKER’S CLAIM?**

A. No, I do not. As I indicated in my Direct Testimony (pages 20-22 and Schedule 3 of Exhibit DCP-2), PUI's actual capital structures have been very volatile over the past five years:

Year	Equity Ratio
2014	42.2%
2015	62.4%
2016	58.9%
2017	48.6%
2018	49.5%
Aug. 31, 2019	57.8%

This demonstrates that, whereas PUI's equity ratio may have been 58.21 percent in the Test Year (*i.e.*, August 31, 2019), an equity ratio of 58.21 percent is not representative of the Company's capital structure over time. Mr. Walker neither acknowledges nor disputes this volatility of PUI's equity ratio in his Rebuttal Testimony.

In addition, as is also indicated in my Direct Testimony (page 19, lines 10-13), a substantial portion of PUI's capital is in the form of "advances from affiliates." This is somewhat unusual among utilities and illustrates that PUI's capital structure is not "market driven" as are the capital structures of the proxy companies (as cited in my Direct Testimony on page 21, lines 13-16). Mr. Walker also neither acknowledges nor disputes this origin of PUI's capital in his Rebuttal Testimony.

Finally, as I indicate in my Direct Testimony (page 21 and Schedule 4 of Exhibit DCP-2), the recent (2014-2018) capital structure ratios of my two proxy groups are:

Capital Structure Ratio Measure	Average	Median
Value Line Group	54.9%	56.2%
Parcell Proxy Group	55.9%	56.5%

Each of these factors, which were included in my Direct Testimony, reflect evidence that PUI's actual capital structures are unreasonable. Accordingly, I disagree

1 with Mr. Walker's claim that I have not presented evidence that the Company's proposed
2 capital structure is unreasonable.

3 **Q. WHAT IS THE NATURE OF MR. CLAYTON'S REBUTTAL TESTIMONY?**

4 **A.** Mr. Clayton's Rebuttal Testimony does not add anything meaningful to the issues
5 of cost of capital. He merely claims, on page 1-2, that the capital structure proposed by
6 PUI is "well within the range of capital structures for other water/wastewater companies."
7 As is shown above, PUI's proposed 58.21 percent common equity ratio is higher than the
8 recent common equity ratios of the proxy groups. In addition, Mr. Clayton fails to
9 acknowledge the facts that PUI's equity ratios have been volatile with the 58.21 percent
10 proposed ratio being at the high end of its historic ratios. Furthermore, he fails to
11 acknowledge the fact that PUI's capital structure contains significant "advances from
12 affiliates" (*i.e.*, from its parent Ni) and thus is not a market-driven capital structure.

13 **III. PROXY GROUP ISSUES**

14 **Q. WHAT ARE THE ALTERNATIVE PROXY GROUPS PROPOSED IN THIS**
15 **PROCEEDING?**

16 **A.** I examined two groups of proxy water utilities in my Direct Testimony (pages 23-
17 25 and Schedule 5 of Exhibit DCP-2). One of these (*i.e.*, the Value Line Group) is the
18 same as Mr. Walker's proxy group, except that it also includes Artesian Resources.

19 In my Direct Testimony (page 24, lines 11-20 and page 25, lines 1-2) I note that
20 two of Mr. Walker's proxy water companies are currently involved in major acquisitions
21 and do not appear to meet one of his selection criteria (not announced subject of
22 acquisition). In his Rebuttal Testimony (page 10, lines 5-9), Mr. Walker maintains that it
23 is acceptable for a proxy company to be acquiring another utility, but not to be acquired by

another utility. Either of these events can have an impact on a utility's stock price and thus its ROE model results (*i.e.*, DCF and CAPM). As a result, it does not matter if the potential proxy company is acquiring or being acquired; either way, it is impacted by the merger. I also note that both the Aqua America (now named Essential Utilities) and SJW mergers were major acquisitions that impacted the respective companies' structure and risk profiles.

Despite this apparent disagreement between Mr. Walker and myself, the impact is moot. My ROE analyses implicitly consider his proxy group (*i.e.*, the Value Line group includes all of his proxy group plus Artesian Resources) as well and, in fact, my ROE results are more reflective of his proxy group than the proxy group I identified.

Q. MR. WALKER MAINTAINS, ON PAGE 11, LINES 3-13 OF HIS REBUTTAL TESTIMONY, THAT YOU DID NOT PRESENT “ANY EVIDENCE REGARDING THE SIMILARITY, OR DISSIMILARITY, OF RISK BETWEEN [YOUR] COMPARISON COMPANIES AND PUI.” WHAT IS YOUR RESPONSE TO THIS ASSERTION?

A. As is indicted in the prior Q&A, I used both my proxy group and implicitly Mr. Walker's proxy group in my ROE analyses. I also noted that my ROE conclusions gave more weight to his proxy group. As a result, Mr. Walker's intended criticism is both incorrect and misleading.

IV. RISK FACTOR ISSUES

Q. WHAT ARE THE RISK FACTOR ISSUES CITED BY MR. WALKER?

A. Mr. Walker cites the following “risk” factors in his Rebuttal Testimony as being differences in our respective analyses: tax reform and relative size of PUI.

Q. MR. WALKER CITES TAX REFORM (PAGES 11-12) AS A RISK FACTOR FOR PUI. WHAT IS YOUR RESPONSE TO THIS ASSERTION?

A. I note, first, that Mr. Walker's reference to tax reform is couched in the context of rating agency (*i.e.*, Moody's and Standard & Poor's) references to the rating metrics these agencies use to establish security ratings. As I indicated in my Direct Testimony (page 16, lines 4-5), PUI's debt is not rated and the Company debt is in the form of Bank of America Term loans and intercompany loans. This latter form of loans, in particular, does not rely on the metrics cited by the rating agencies.

Q. MR. WALKER CITES THE RELATIVE SIZE OF PUI AS A RISK FACTOR (PAGES 12-13). WHAT IS YOUR RESPONSE TO THIS?

A. I discussed, at length, the impact of size on risk for utilities in my Direct Testimony (pages 47-50 and Schedules 12 and 13 of Exhibit DCP-2). Mr. Walker neither acknowledged nor refuted this in his Rebuttal Testimony.

Q. FINALLY, MR. WALKER MAINTAINS (PAGES 14-15) THAT YOUR REFERENCE TO LOWER EXPECTED INVESTMENT RETURNS WAS NOT CORRECT. DO YOU HAVE ANY RESPONSE TO HIS CLAIM?

A. Yes, I do. Long-term total returns (*i.e.*, 1926-2018¹) in the equity markets have been:

<u>Stock Index</u>	<u>Geometric</u>	<u>Arithmetic</u>
Large Cap Stocks ²	10.0%	11.9%

The most recent returns for the S&P 500 (for the period ended December 31, 2019), have been:³

¹ 2019 SBBI Yearbook, Stocks, Bonds, Bills and Inflation, Duff and Phelps.

² S&P 500.

³ Vanguard 500 Index Fund Report for 2019.

<u>Time Frame</u>	<u>Total Return</u>
3 Years	10.23%
5 Years	9.86%

This demonstrates that returns since the Great Recession have been lower than the longer-term periods. It is thus clear that the expectations I cited in my Direct Testimony have turned out to be accurate and Mr. Walker's claims are incorrect.

V. DISCOUNTED CASH FLOW MODEL ("DCF") ISSUES

Q. WHAT ARE THE DCF ISSUES RAISED IN MR. WALKER'S REBUTTAL TESTIMONY?

A. Mr. Walker cites the following perceived issues in DCF analyses: use of retention growth rates, use of analyst' earnings per share ("EPS") forecasts, and the differences in book values and market values and related impact of the DCF results.

Q. WHAT ARE YOUR RESPONSES TO THE FIRST TWO ISSUES CITED BY MR. WALKER?

A. As is clearly shown on Schedule 6 of Exhibit DCP-2 of my Direct Testimony, the highest DCF results that I derived, and the results that I focus on in my 9.1 percent DCF conclusions, are the First Call EPS forecasts. Mr. Walker does not acknowledge this in his Rebuttal Testimony.

Q. WHAT IS THE NATURE OF MR. WALKER'S CLAIM THAT THERE IS A DIFFERENCE BETWEEN THE MARKET VALUES AND BOOK VALUES OF THE PROXY GROUPS?

1 A. Mr. Walker is claiming that the market value of the proxy groups exceeds the book
2 values and, thus, the use of market-based models such as DCF do not provide a proper
3 estimate of the cost of equity for utilities (pages 20-23).

4 Q. **DO YOU AGREE WITH THIS PROPOSITION?**

5 A. No, I do not. As I have noted elsewhere in my Direct Testimony, investors are well
6 aware that utilities have their rates established based upon the book values of their rate base
7 and capital structure, as well as expenses and revenues. As a result, the stock prices of
8 utilities reflect the recognition of book value for utilities. Consequently, there is no logical
9 basis for “adjusting” the stock prices (and thus, DCF results) of utilities to reflect any
10 perceived divergence between book value and market value.

11 **VI. CAPITAL ASSET PRICING MODEL (“CAPM”) ISSUES**

12 Q. **WHAT ARE THE CAPM ISSUES CITED BY MR. WALKER?**

13 A. Mr. Walker claims the following issues with my CAPM analyses: use of both
14 market returns and accounting returns, use of both capital gains and income returns in the
15 market returns, use of both arithmetic and geometric returns, and size premiums.

16 Q. **WHAT ARE MR. WALKER’S CLAIMS REGARDING THE USE OF BOTH**
17 **MARKET RETURNS AND ACCOUNTING RETURNS IN DEVELOPING THE**
18 **RISK PREMIUM COMPONENT OF THE CAPM?**

19 A. Mr. Walker maintains (pages 23-24) that it is not proper to use accounting returns
20 (*i.e.*, earned ROEs and interest rates) in developing the risk premium component.

21 Q. **WHAT IS YOUR RESPONSE TO THIS ASSERTION?**

22 A. I disagree with Mr. Walker. As I indicate on pages 33-34 of my Direct Testimony,
23 I used measures of both book returns (*i.e.*, accounting returns) and market returns in

1 developing my CAPM risk premium components. The rates (*i.e.*, prices) of public utilities
2 are established based upon the book values of their rate base and capital structures, as well
3 as the book levels of expenses and revenues. As such, it is appropriate to consider the level
4 of return on book equity in the determination of the cost of equity (which is applied to the
5 book level of common equity in the capital structure). I also note that the risk premium I
6 derive from my use of book rates of return is the highest of the three risk premium measures
7 I considered in my CAPM analyses. Mr. Walker does not acknowledge this in his
8 Rebuttal Testimony.

9 **Q. WHAT IS MR. WALKER'S CLAIM ABOUT THE USE OF BOTH CAPITAL**
10 **GAINS AND INCOME RETURNS IN DEVELOPING THE MARKET RISK**
11 **PREMIUM?**

12 **A.** Mr. Walker claims (page 25, lines 8-14) that, in using the SBBI studies to determine
13 long-term (*i.e.*, 1926-2018) risk premiums, one should use total returns for common stocks
14 (*i.e.*, dividends and capital gains) and only income returns on long-term government bonds.

15 **Q. DO YOU AGREE WITH MR. WALKER ON THIS POINT?**

16 **A.** No, I do not. Mr. Walker is proposing that we should compare, in developing a risk
17 premium, total returns on common stocks with only income returns on bonds. This
18 excludes the capital gain component on bonds (which is the lower return of the two
19 components) and makes the resulting risk premium appear higher. Such an approach is
20 inconsistent and does not reflect an "apples to apples" comparison.

21 **Q. WHAT IS THE NATURE OF MR. WALKER'S CLAIM THAT ONLY**
22 **ARITHMETIC RETURNS SHOULD BE USED IN DEVELOPING LONG-TERM**
23 **AVERAGE RETURNS AND RISK PREMIUMS?**

1 A. Mr. Walker states (pages 25-26) that only arithmetic returns should be used to
2 measure long-term average growth rates and thus risk premiums.

3 **Q. DO YOU AGREE WITH MR. WALKER?**

4 A. No, I do not. It is apparent that investors have access to both arithmetic and
5 geometric returns in the materials provided to them by investment advisory services and
6 mutual funds. For example, Value Line (one of the sources of EPS growth cited by Mr.
7 Walker in his DCF analysis on Schedule 13 of his Direct Testimony) reports growth rates
8 on a compound (*i.e.*, geometric) basis, not on an arithmetic basis. In addition, mutual funds,
9 following Securities and Exchange Commission requirements, report returns on a
10 geometric basis. Based upon this, I find it difficult to accept Mr. Walker's position that
11 only arithmetic returns are considered by investors and are the only appropriate measure
12 of returns. Finally, as I noted previously, I considered both arithmetic and geometric
13 returns in my analyses.

14 **Q. MR. WALKER ALSO CITES A "SIZE ADJUSTMENT" IS A NECESSARY**
15 **COMPONENT TO THE CAPM RESULTS. WHAT IS YOUR RESPONSE TO**
16 **THIS?**

17 A. I previously discussed the lack of need for a size adjustment for a utility in my
18 Direct Testimony. As a result, I do not discuss this further here.

19 **VII. COMPARABLE EARNINGS ("CE") ISSUES**

20 **Q. WHAT CE ISSUES DOES MR. WALKER CITE IN HIS REBUTTAL**
21 **TESTIMONY?**

1 **A.** Mr. Walker's claims (pages 29-30) first cite the appropriateness of my use of the
2 ROEs of the S&P 500 index in my CE analyses. In addition, he claims that the proxy
3 groups' ROEs are higher than my CE conclusions.

4 **Q. WHAT IS YOUR RESPONSE TO THE FIRST CLAIM OF MR. WALKER?**

5 **A.** I note that my reference to the S&P 500 group is provided as a check and is not
6 used as a direct measure of the ROE for PUI. I also note in my Direct Testimony that the
7 S&P 500 is riskier than water/wastewater utilities (page 40, lines 13-20 and Schedule 11
8 of Exhibit DCP-2 of my Direct Testimony).

9 **Q. PLEASE RESPOND TO MR. WALKER'S SECOND CLAIM.**

10 **A.** Mr. Walker's Rebuttal Testimony cites (page 29, lines 11-15) the projected ROEs
11 of the proxy groups. His citation only acknowledges selective portions of my CE analyses
12 for the proxy water groups. As I indicate in my Direct Testimony (pages 39-40 and
13 Schedule 9 of Exhibit DCP-2), over the past two business cycles the proxy groups have
14 had average ROEs of 9.1 percent to 9.7 percent. Meanwhile, investors priced the stocks of
15 these groups at twice the book value of the stock, indicating an acceptance of these returns.
16 Prospective ROEs are higher, but the most recent market-to-book ratios are over 300
17 percent (*i.e.*, stock price is a multiple of three times book value), which indicates these
18 higher returns exceed the cost of capital.

19 **Q. DO YOU HAVE ANY FURTHER COMMENTS ABOUT MR. WALKER'S**
20 **RETURN ON EQUITY RECOMMENDATION?**

21 **A.** Yes, I do. In the current proceeding, Mr. Walker is recommending a 10.50 percent
22 return on equity for PUI. In testimony in 2019 for an affiliated company of PUI (Palmetto
23 Wastewater Reclamation, LLC) Mr. Walker recommended a 10.75 percent return on

1 equity. As a result, Mr. Walker is implicitly recognizing that the cost of equity has declined
2 over the past year.

3 **Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

4 **A.** Yes, it does.